DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 15428
San Diego, Calif. 92115

36 Letters per Year — $60.00 Annually

Registered with the Securities Exchange Commission

February 19, 1969 Letter 419

THE MARKET: On February 7 the D-J Rail Average closed at 279.88, thus bettering the December, 1968 all-time high of 279.48. Industrials rose 1.18 points on that day to close at 947.85, still well under their all time high of 995.15 established on February 9, 1966.

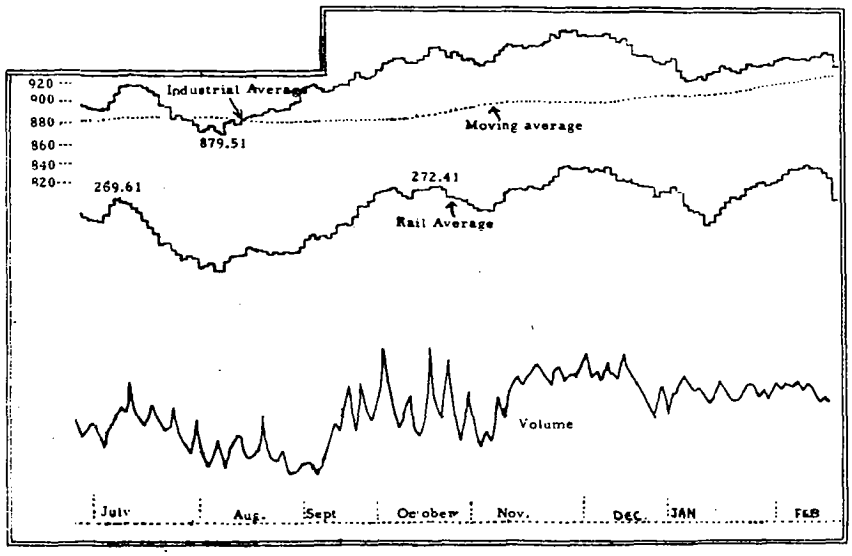
By closing at a new historic high, the D-J Rails recorded their third new peak since 1966, each peak unconfirmed by a comparable high in Industrials. To repeat a little history, Industrials hit their bull market high of 995.15 in February, 1966, while rails that same month closed at 271.72. During 1967 Rails rallied to a high of 274.49 while Industrials refused to confirm. In late 1968 Rails again advanced, closing at a high of 279.48, and again Industrials refused to join the show. Finally, last week Rails closed at 279.98 with Industrials substantially below even their 1968 peak of 985.21.

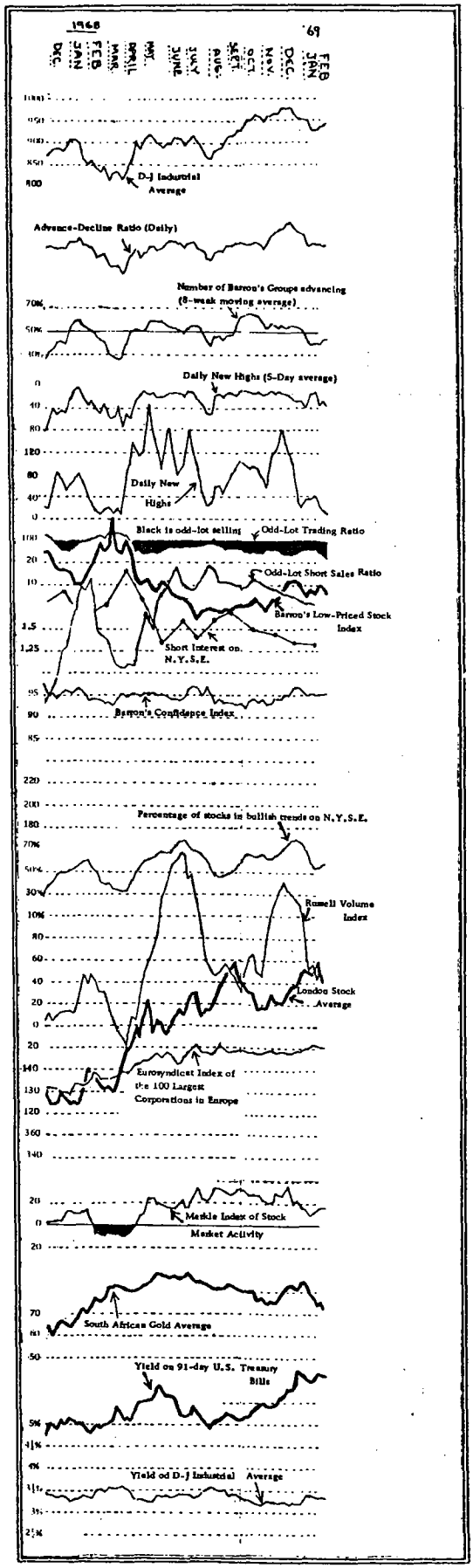
The action of the two Averages thus creates a series of three major non-confirmations since 1966. And unless Industrials can confirm by bettering 995.15, I would say that this market is on a more dangerous footing than ever.

During this period of exceptional Rail action, the majority of stocks on the N.Y.S.E. have been "churning," and this is attested to by the fact that since mid-January the advance-decline ratio has been moving virtually sideways.

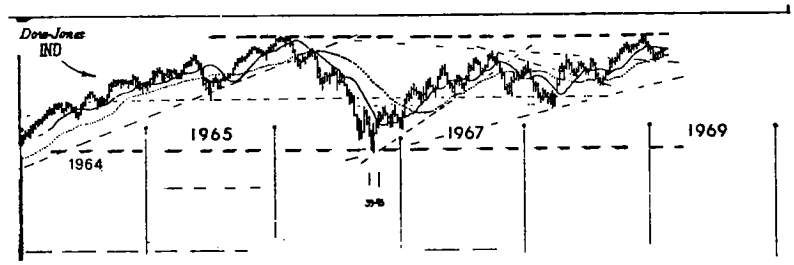
Selectivity in the market has grown vicious with the great majority of so-called growth stocks showing attrition. In the meantime, such defensive groups as Tobaccos and Utilities provided the upward impetus helped by such high-yielding groups as Steels and Rails.

Some of the reasons for the market hesitancy are now appearing. For the fourth quarter of 1968, according to the Wall Street Journal, corporate profits slowed their advance considerably. Against year-to-




1968
'69
D-J Industrial Average
Advance-Decline Ratio (Daily)
Number of Barron's Groups advancing (8-week moving average)
Daily New Highs (5-Day average)
Daily New Highs
Black is odd-lot selling
Odd-Lot Trading Ratio
Odd-Lot Short Sales Ratio
Barron's Low-Priced Stock Index
Short Interest on N.Y.S.E.
Barron's Confidence Index
Percentage of stocks in bullish trends on N.Y.S.E.
Russell Volume Index
London Stock Average
Eurosyndicat Index of the 100 Largest Corporations in Europe
Merkle Index of Stock Market Activity
South African Gold Average
Yield on 91-day U.S. Treasury Bills
Yield on D-J Industrial Average

year advances of 11.1% for the first quarter of 1968 (compared to first quarter 1967), an advance of 10.2% for second quarter 1968, 13.6% for third quarter 1968, the fourth quarter of 1968 shows a corporate profit advance of only 7.3%. And the fourth quarter, states the Journal, would have shown an even lower rate of advance had it not been for major accounting changes at many leading corporations.



From the long term standpoint, few people realize that the Dow Industrials have been moving within a 251 point range since 1964. The accompanying chart (courtesy of Quote Digest) illustrates this point, and I have drawn in dashed lines to show the five-year "trading range." At present or until proved otherwise, I would say that the Dow has formed a major double top in the 985-995 range, this despite unprecedented infusions of inflation and a continuing business boom.

One studies this chart and wonders what mysterious force has been holding the Dow back, thwarting major attempts in 1967, 1968 and 1969 to better the 1966 bull market high of 995.15. My answer is that the primary bear forces which took over following February 9, 1966, have proved stronger than all the manipulations of the President, the Treasury and the Federal Reserve Board combined.

How much longer can we expect the Dow to hold within the five-year range? Here is one way of figuring. Bear markets tend to last approximately one-third as long as their preceding bull market. The bull market of 1949-1966 lasted 17 years, and I would therefore expect the bear market which began in 1966 to last five or six years—or until 1971 or 1972. But here we are with the bear market (in terms of duration) probably about half over. What is left is extent of decline, and from the standpoint of extent we have not started to go down yet.

Therefore, when the bear forces take hold I would expect them to do so with unusual severity. And because the primary forces have been "held back" for three years I would expect the downside action, when it comes, to carry further than would ordinarily be expected. Remember, since 1966 instead of the excesses of the 1949-66 bull market being squeezed out, those excesses have built up even further. The greater the excess, the more severe the bear market correction needed to bring matters back to "normal."

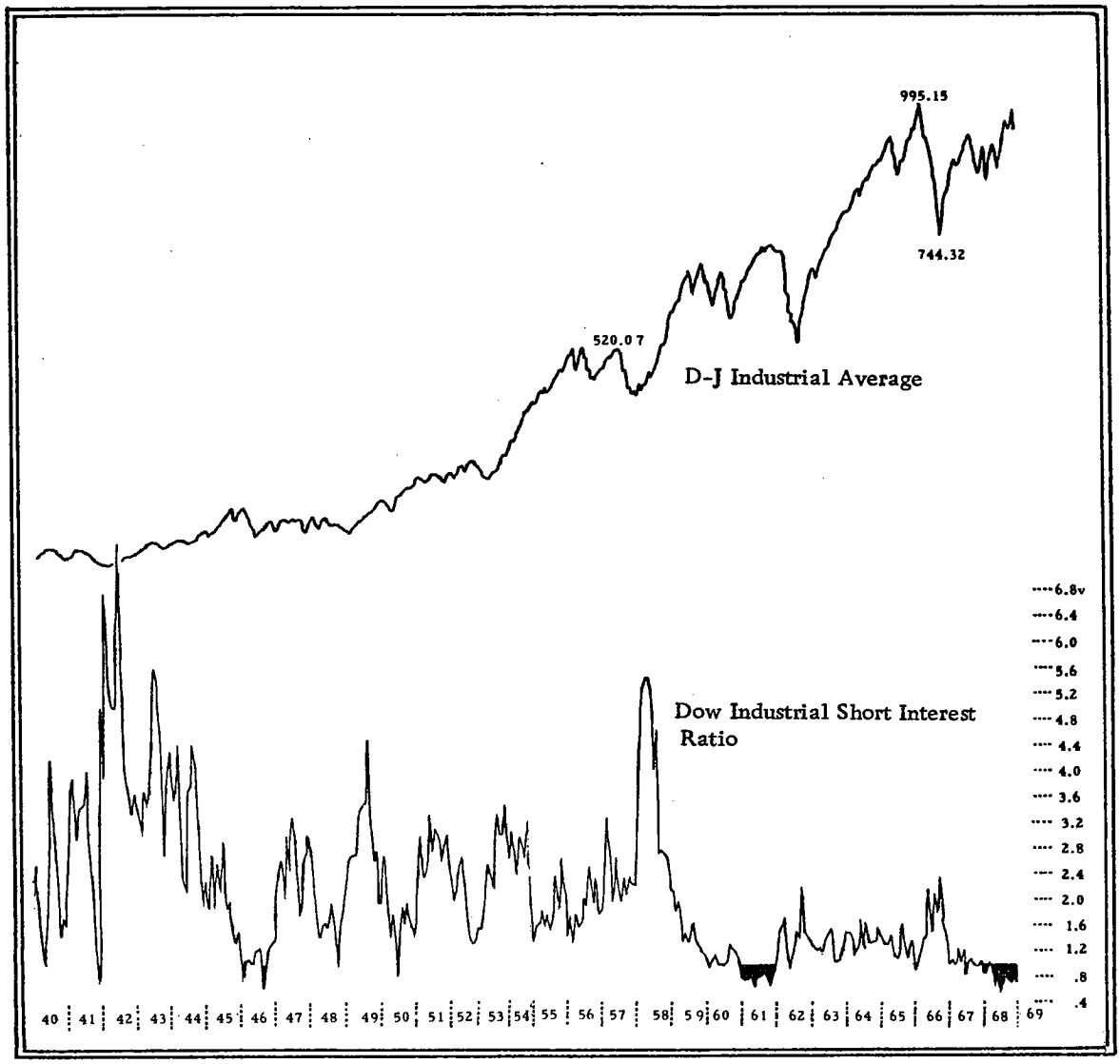
DOW SHORT INTEREST RATIO (see chart on page 3): This is the important new indicator developed by Bill Gordon of Indicator Digest; I have been keeping my readers abreast of the Dow short interest ratio for about a year. A study of this indicator going back to 1932 suggests that it is much more accurate (and therefore more useful) than the more widely followed short interest ratio of all stocks on the N.Y.S.E. The Dow short interest ratio is laboriously tabulated each month by computing the total short interest in the 30 Dow stocks and then dividing this figure by the total number of shares traded in those 30 stocks over the same period.

The Dow ratio is particularly interesting at this time. Note on the chart that since 1940 there have been only two extended areas (black on chart) in which the Dow ratio dropped under the critical 1.0 area. The Dow ratio sank below 1.0 in January, 1961, and held below 1.0 steadily until January, 1962, a period of 13 months. Following that the market caved in (i.e., the 1962 collapse).

In January, 1968, the Dow ratio again sank under 1.0, and except for the single month of March, 1968, the Dow ratio has held under 1.0 ever since. As this is written, the Dow ratio has held under 1.0 for 12 out of 13 consecutive months. This study is now saying "danger," in exactly the same way that it said danger during the 1961-62 period. The timing, of course, is indefinite, but as of this writing a sufficient period of time has elapsed (exactly the same number of months under 1.0 as 1961-62) to put this indicator in the critical reading area.

SQUEEZE STILL ON: Two weeks ago Barron's (February 10) entered a brilliant plea on its front page editorial for an end to special concessions on interest rates for U.S. Government agencies. After years of idle chatter about ending inflation (a la President Johnson), it remains to be seen whether President Nixon will deliver the goods. It's a matter of allowing the forces of supply and demand to express themselves in the interest rate marketplace.

Aside from the manipulated "special rates" enjoyed by assorted Government agencies, interest rates certainly have been expressing themselves in most other areas. "Ten percent money is here," states economist Eliot Janeway, and he continues, "That's the real cost of money when the Reserve Center banks are forced to pay up to 8% for their short-term Eurodollar borrowings."



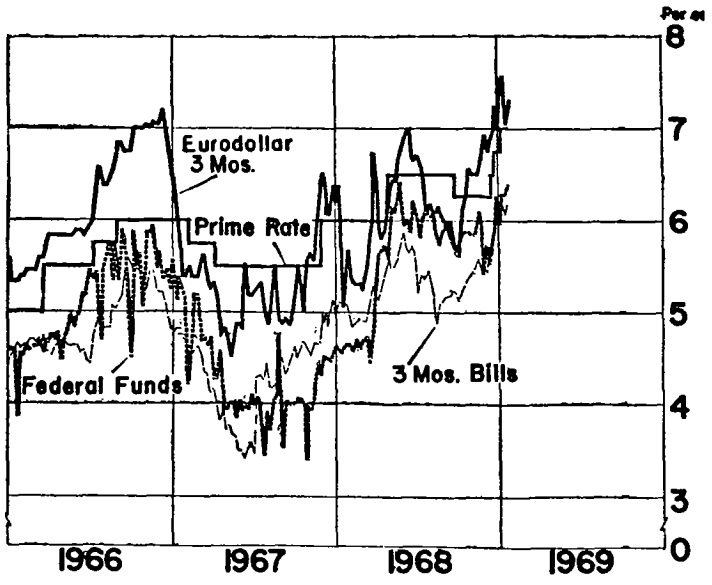
Fantastic rates of interest are being posted elsewhere. For instance, last week the widely-followed Municipal Bond Index recorded an average yield of 4.95 (tax free), highest level in thirty-five years. During the same week Moody's Aaa-rated Bond index touched a yield of 6.59%, an all-time high. The bellwether 91-day Treasury bills are holding consistently above in the 6.10% yield area, which is roughly 1% above the going savings rate at banks and saving & loan associations.

The mid-February Treasury refunding was historic in that it provided two issues, a 15-month note priced at 99.95 to yield 6.42% interest, and a 7-year note priced at 99.75 to yield 6.29%. As Babson's Report put it last week, "This is the most our Government has paid on a coupon issue since the year Lincoln was assassinated."

Mortgage-loan rates have now reached 8% in many places, 9% for some buyers here on the West Coast. Even more fantastic is the total debt picture which shows that interest payments by individuals on mortgages, auto and other loans have exploded from $14.7 billions in 1960 to a staggering $31 billions in 1968. As U.S. News and World Report put it last week, "There's never been anything quite like the financial pinch of today's interest rates."

The accompanying chart (see page 4) from the Weekly Bond Buyer presents a startling picture of what's happening today. Note the steady push upward since 1967 of all rates. Note also that the huge Eurodollar market has now moved into the 7% yield area. There are now 25 American banks tapping the Eurodollar market, a market which consists of roughly $20 billion in funds. As American banks in need of funds tie up Eurodollars, rates are rising in Europe and interest rates throughout the Free World tend to go through the ceiling.

Recently the Assistant Secretary of Commerce for Affairs, Mr. William Chartener, raised another specter on the debt horizon. "Is it not possible," he asked, "that large deficits in State and local finances would yield inflationary pressures similar to those caused by the Federal budget deficits?"



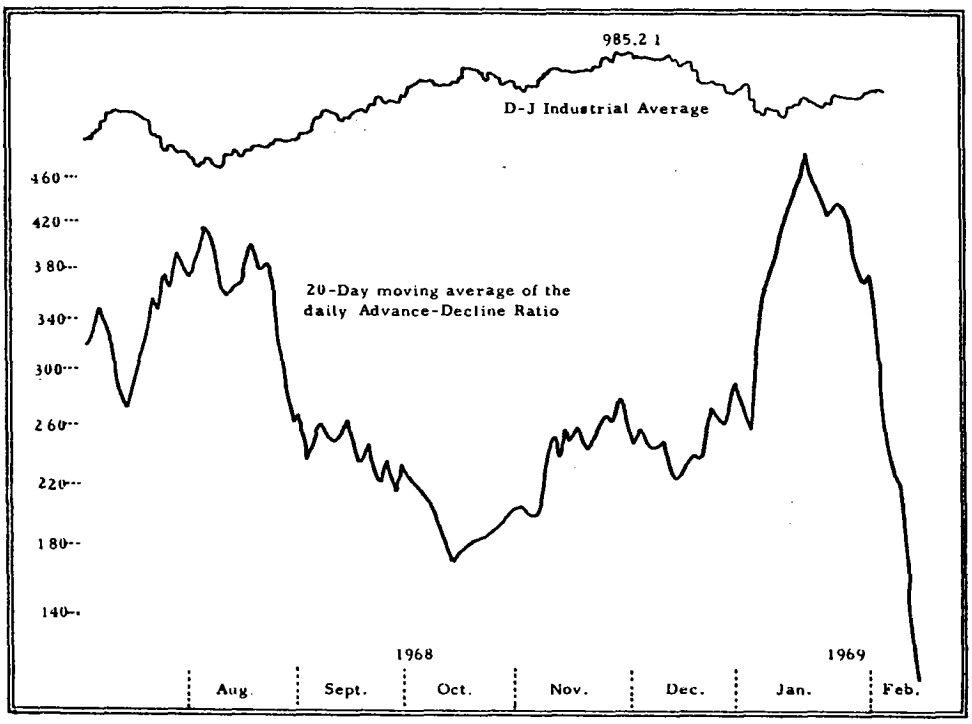
The fact is that state and local governments may now be running deficits of around $24 billion dollars, and as their fiscal plight worsens these deficits are calculated to grow larger. Much of this deficit is covered by grants from the Federal Government and much of it is covered by issuance of bonds. Either way, the pressure from State and local governments is increasing and the Municipal bond market creaks lower and lower in response to this pressure.

Conclusion: It would seem that at last the Fed is slowing down the money supply while interest rates in the free markets climb inexorably higher. At a time when the well nigh universal opinion holds that inflation is unstopable, the twin forces of fiscal and monetary restraint are confronting the forces of inflation. In my opinion, before 1969 is out something is going to give, and it will be either the pressure in the money market or the boom itself. My guess would be the latter.

SPECIAL STUDY: In Letter 410 I introduced an indicator which I have found to be extremely helpful in gauging the technical position of the market. The indicator (see chart) is a 20-day moving average of the advance-decline ratio.

This is the rationale for the advance-decline average. During the early stages of a market advance, it is characteristic for a great many stocks and stock groups to rally. As the advance progresses, a decreasing number of stocks stay in the advancing parade. Finally, near the top of the advance there may be as many stocks moving sideways or declining as there are advancing.

During a downward movement the opposite type of action is characteristic. As a slide progresses an increasing number of stocks enter the decline. Finally near the bottom of the decline almost all stocks may be heading lower, and this gives rise to the so-called selling climax. At such times we might see a day or so in which perhaps 100 to 150 stocks advance while 1000 to 1100 stocks decline.



In other words, near a selling climax bottom the opposite of "churning action" at the top is seen. Few people are aware of this phenomenon of huge sweeping movement near the bottom of a major decline and little or no movement near the peak of a major advance.

Now, how can we measure this movement? The advance-decline ratio measures the advancing or declining tendencies of all stocks on the N.Y.S.E. during any given day. If we simply add the advance-decline ratio figures for the last 20 days we will get a total showing of the "activity" during those 20 days. For instance, if there was great activity we will be adding twenty relatively large A-D figures (since we do not care whether it was up or down action we simply add all 20 A-D figures regardless of whether they are plus or minus). If there was little action during the 20 days we will be adding 20 rather small A-D figures, and this could be indicative of the churning type of motion we get near a top. Theoretically, if the A-D ratio was showing no motion at all for 20 days we would add 20 zeros and the 20-day average would plunge to zero, the perfect or ultimate top.

Studying the chart we note that the A-D ratio 20-day average moved up to the 440 area during the July-August, 1968 decline. This indicated that a great many stocks were moving together, and it also indicated that the market was nearing a bottom area. The Dow turned up from the 879.51 low of August 15 and headed higher. In the meantime, the 20-day average started to decline, hitting a final low in the 160 area in October. From that point, churning became increasingly evident, fewer and fewer stocks were staying with the advance. The Dow finally topped at 985.21 on December 3, 1968. A sharp sell-off followed, and the decline sent the 20-day average into the 480 zone by mid-January. This suggested that the market was sold out.

From late-December, 1968 to the present the action of the Dow and the 20-day average appeared rather strange. The rally from the 921.25 December low was labored and sluggish. By February the Industrials had pushed only to the 940-950 area, while the 20-day average of the A-D ratio had declined precipitously. The reading was that a great deal of churning (i.e., little motion on the A-D ratio) was accompanying the rally in the Dow.

By last week the 20-week average had sunk to the 100 area, an extremely low reading and one which suggests that a top is being formed. In general, I would say that a drop by the 20-day average below 140 (while the Dow is in a rallying phase) signifies a top, while a rise of the 20-day average to the 420 area (while the Dow is declining) indicates the approach of a bottom.

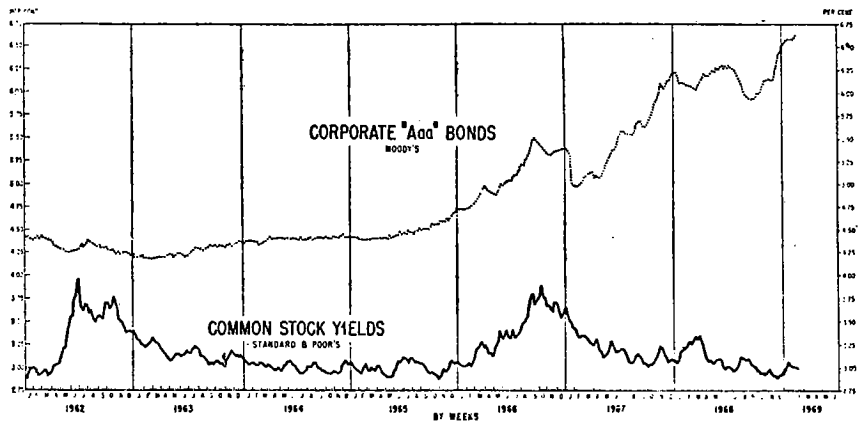
It should be stressed that tops are traditionally much more extended and difficult to identify than bottoms. Note on the chart that the bottoms appear with violent, well-defined upward thrusts of the 20-day average while tops are less clear and formed over a much greater length of time.

ANOTHER HISTORIC RECORD: Last week the yield spread (see chart) between Moody's Aaa-rated bonds and the broad Standard and Poor's 500 Stock Average widened to a record 3.57% in favor of Aaa bonds. The yield on the 500 Stock Average was 3.04% while the yield on the Aaa Bond Average rose to 6.63%, highest in history. Thus the new record negative yield spread of 3.59% surpasses the previous record of 3.57% recorded on December 17, 1968.

It is important to note that the S & P 500 on December 17 was higher than it is today. Thus, despite the recent correction, the yield spread between stocks and bonds is now more "out-of-kilter" than ever. The only factors which will correct the current negative yield spread is a rally in bonds or a decline in stocks or both.

In the face of the wild yield spread discussed above, it would seem that the Federal Reserve Board may at last be taking steps to halt inflation. The money supply in the U.S. has now declined for three weeks in a row, dropping at a slight rate of 2.5% annually. The monetary base has dipped for two weeks, Federal Reserve credit has declined for three weeks, and money supply plus time deposits has dropped sharply for three weeks.

Of course, one swallow does not make a credit crunch, but what can be said is that the money supply explosion which existed under President Johnson seems to have come to an end. That could mean trouble in the stock market over the near future.



LATE NOTES: On Monday, Feb. 17 the stalemate was broken by a 14 point drop in the Dow Industrials. As this is written, Tues. morning, the Dow is down another 10 points. A huge "head-and-shoulders" has formed with a critical point at 921 in the Dow. Watch to see if that level is broken.